**Office of Chief Counsel**
**Internal Revenue Service**

# memorandum

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CBMcClure

date: NOV 2 4 1999

to: Chief, Examination Division, Houston District
Attention: [redacted], International Examiner

from: District Counsel, Houston District, Houston

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ubject: **Interest Netting Prior to Allocation and Apportionment**
**[redacted] Examination ([redacted] - [redacted])**

You have requested our advice regarding [redacted]'s disclosed position that it is netting interest expense against interest income, prior to allocating and apportioning its interest expense under the regulations implementing I.R.C. § 861.[1] [redacted] relies on Dresser Industries, Inc. v. Commissioner, 911 F.2d 1128 (5th Cir. 1990), rev'g 92 T.C. 1276 (1989), Computervision International Corp. v. Commissioner, T.C. Memo. 1996-131, and Coca-Cola Corp. v. Commissioner, 106 T.C. 1 (1996), in support of its position. [redacted] further asserts that Temp. Treas. Reg. § 1.861-9T(a), providing that "the term interest refers to the gross amount of interest expense incurred by a taxpayer in a given tax year," will be found invalid, citing the legislative history to the Tax Reform Act of 1986. For the reasons stated below, we disagree with [redacted]'s position and recommend that the appropriate interest allocation adjustments be made.

Temp. Treas. Reg. § 1.861-9T provides rules for the allocation and apportionment of interest expense in determining income from foreign and domestic sources under I.R.C. §§ 861 and 862. Temp. Treas. Reg. § 1.861-9T(a) provides in pertinent part that "[a]ny expense that is deductible under section 163

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[1] [redacted] disclosed this position by filing Form 8275-R for the [redacted] and [redacted] taxable years, to avoid potential applicability of the accuracy-related penalty under section 6662(a) for disregarding a Treasury regulation. We express no opinion herein whether [redacted]'s method of interest allocation has a "reasonable basis" within the meaning of I.R.C. § 6662(d)(2)(B)(ii)(II). If the position were found to have a reasonable basis, the penalty would not apply. However, we do agree that [redacted] has stated the proper standard for relief from the penalty. See, infra, pp. 14-15.

(including original issue discount) constitutes interest for purposes of this section . . . ," and further provides that

> *[t]he term interest refers to the gross amount of interest expense incurred by a taxpayer in a given tax year.* The method of allocation and apportionment for interest set forth in this section is based on the approach that, in general, money is fungible and that interest expense is attributable to all activities and properties regardless of any specific purpose for incurring an obligation on which interest is paid. . . . the fungibility approach recognizes that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds. When money is borrowed for a specific purpose, such borrowing will generally free other funds for other purposes, and it is reasonable under this approach to attribute part of the cost of borrowing to such other purposes. Consistent with the principles of fungibility, except as otherwise provided, the aggregate of deductions for interest in all cases shall be considered related to all income producing activities and assets of the taxpayer and, thus, allocable to all the gross income which the assets of the taxpayer generate, have generated, or could reasonably have been expected to generate. In the case of the interest expense of members of an affiliated group, interest expense shall be considered to be allocable to all gross income of the members of the group under § 1.861-11T. That section requires the members of an affiliated group to allocate and apportion the interest expense of each member of the group as if all members of such group were a single corporation.

(Emphasis added.)

The Tax Court as well as two courts of appeals and a magistrate judge have addressed the issue of whether a taxpayer may net interest expense against interest income within the meaning of the regulations under section 861, primarily in the context of determining the "combined taxable income" (CTI) of a domestic international sales corporation (DISC). However, each of the decided cases dealt with versions of the regulation in effect prior to the promulgation in 1988 of the regulation quoted above, which added the italicized phrase "[t]he term interest refers to the gross amount of interest expense incurred by a taxpayer in a given tax year." (Emphasis added) Nevertheless, each opinion analyzes the significance to the issue of the principle that money is fungible, on which principle [redacted] relies to assert that the 1988 regulation "exceeds statutory authority," and "does not reflect congressional (sic) intent." [redacted] claims that "in the legislative history of the Tax Reform Act of 1986,

Congress explicitly mandated that the interest expense allocation and apportionment rules be based on the premise that money is fungible," and that the regulation requiring that gross rather than net interest be allocated and apportioned is inconsistent with this premise. [redacted] relies on H.R. Rep. No. 426, 99th Cong. 2d Sess. 374 (1985) and S. Rep. No. 313, 99th Cong. 2d Sess. 350 (1986), for its assertion that "Congress set forth that tax law in this area should reflect 'economic reality'."

[redacted]'s reliance on cases interpreting prior versions of the regulation, as well as on the legislative history of the 1986 Act, is misplaced. The regulation in effect for the years under examination both recognizes that money is fungible and explicitly requires that gross - not net - interest be allocated and apportioned. This clarification of already existing law on the subject both reasonably interprets sections 861 and 862 and comports with expressed Congressional intent. The regulation is therefore a valid interpretive regulation which should be upheld.

**Case Law Interpreting the Treasury Regulation**

The case law considering the regulation prior to its amendment in 1988 is inconsistent regarding whether the allocation of gross or net interest better accords with the premise that money is fungible. [redacted] argues that its position is supported by the Dresser, Computervision and Coca-Cola cases, as well as two Actions on Decision: AOD-CC-1986-022 (Feb. 26, 1996); AOD-CC-1986-023 (Feb. 26, 1996). The case that comes closest to supporting [redacted]'s position is Dresser Indus. v. Commissioner, 911 F.2d 1128 (5th Cir. 1990). However, the Court of Appeals for the Second Circuit in Bowater v. Commissioner, 108 F.3d 12 (2nd Cir. 1997), criticized the Fifth Circuit's analysis in Dresser, and reached the opposite conclusion. Moreover, all the cases address the regulation as in effect prior to the 1988 clarification that "[t]he term interest refers to the gross amount of interest expense incurred by a taxpayer in a given tax year."

In Dresser, 911 F.2d at 1136, the Fifth Circuit Court of Appeals reversed a decision by the Tax Court which had held that, when computing the combined taxable income (CTI) of a domestic international sales corporation (DISC) and its related entity under I.R.C. § 994(a)(2), a taxpayer is not entitled to net interest income against interest expense prior to allocation. Section 994(a)(2) provides a two-step formula for computing CTI: (1) the taxpayer allocates to each item of gross income all expenses directly related to exporting, and (2) the taxpayer then apportions other expenses among all items of gross income on a ratable basis. See I.R.C. § 994(a)(2). The court explained:

> Thus, the [CTI] of a DISC and a related person with respect to the sale by the DISC of export property would be determined by deducting from the DISC's gross receipts [1] the related person's cost of goods sold with respect to the property, the selling, overhead, and administrative expenses of both the DISC and the related person which are directly related to the sale of the export property and [2] a portion of the related person's and the DISC's expenses not allocable to any specific item of income . . .

Dresser, 911 F.2d at 1132 (quoting H.R. Rep. No. 533 at 1887-88; S. Rep. No. 437 at 2013-14).

During its 1976 and 1977 taxable years, the taxpayer in Dresser had earned interest income of $36 million from investment of surplus cash. Dresser, 911 F.2d at 1130. The taxpayer had also incurred interest expense of $58.8 million, none of which was directly traceable to export sales through its DISC. The Commissioner argued that the taxpayer was required to apportion a ratable share of its gross interest expense to its DISC. The taxpayer argued, on the other hand, that it was entitled to offset its interest income against its interest expense, and then apportion a ratable share of the resulting net interest expense to its DISC.[2]

The taxpayer asserted that interest netting for purposes of computing CTI was permissible, by analogy to the treatment of interest for purposes of computing the 50 percent limitation on the allowance for depletion under I.R.C. § 613(a). I.R.C. § 613(a) provides for an allowance for depletion in the case of mines, oil and gas wells and other natural deposits, based upon a percentage of the taxpayer's gross income from the property, not to exceed 50 percent of the taxpayer's taxable income from the property. Taxable income is calculated by subtracting certain expenses (including that portion of interest expense properly allocable to the mining phase of operation) from gross income from mining operations. The taxpayer relied on the Fifth Circuit's decision in General Portland Cement Co. v. United States, 628 F.2d 321, 344 (5th Cir. 1980). In that case, the Fifth Circuit phrased the relevant question as "whether taxpayer's interest income is related to its actual cost for interest in borrowed funds." Id. The Fifth Circuit concluded that a taxpayer would not have earned interest income had it not

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[2] The practical result of such interest netting is to increase the CTI and the tax benefit available to the taxpayer from its DISC operations. Dresser, 911 F.2d at 1132.

first incurred interest expense. Thus, reasoned the court in General Portland, since the actual cost of borrowing is represented by net interest, a taxpayer should be entitled to offset its interest income against its interest expense in calculating "taxable income from [mining] property."[3]

The Commissioner in Dresser argued that the legislative history of and regulations under section 994 required the apportionment of gross interest expense. As support, the Commissioner noted that the apportionment rules under section 994 reference the regulations under Code section 861. These regulations, argued the Commissioner, require the apportionment of gross interest expense. Although the Tax Court recognized some conceptual similarity between sections 613 and 994,[4] it nevertheless held for the Commissioner. Dresser Indus. v. Commissioner, 92 T.C. 1276, 1284 (1989). First, the Court noted that a literal reading of section 994 excludes interest income from the computation of CTI altogether. Section 994 is limited to qualified export receipts from the sale of export property. Since the parties agreed that the interest income at issue was not related to the sale of export property, it could not qualify as export receipts under the statute. Id. at 1285. Second, the Tax Court explained that the legislative history of the DISC provisions supported the Commissioner's position. Id. at 1285 (citing H. Rept. 92-533 (1971), 1972-1 C.B. 498, 538; S. Rept. 92-437 (1971), 1972 C.B. 559, 619). Neither party had cited to any authority permitting interest netting for computing CTI. Rather, explained the court, the computation of CTI is governed by reference to the Treasury Regulations under section 861. Id.

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[3] In 1984, the Tax Court followed the Fifth Circuit's decision in General Portland. See Ideal Basic Indus. v. Commissioner, 82 T.C. 352, 400-02 (1984). The dispute in Ideal Basic was whether the term "financial overhead" in Treas. Reg. § 1.613-5(a) should include gross interest expense or net interest expense. Relying on General Portland, the Tax Court concluded that the term includes net and not gross interest expense.

[4] The Tax Court observed that both sections provide special tax incentives to a designated activity, i.e., mining or exporting. Second, the Court observed that both sections determine a tax incentive by computing taxable income realized through the designated activity. Finally, noted the Court, both sections limit the tax benefit to 50 percent of the designated activity's income. Dresser, 92 T.C. at 1284.

(citing Treas. Reg. § 1.994-1(c)(6)(iii)).[5] The Court cited the then current Treas. Reg. § 1.861-8(e)(2), which does not provide for interest netting before allocation and apportionment. Instead, Treas. Reg. § 1.861-8(e)(2) requires a taxpayer to allocate interest expense ratably to "all income producing activities." Finally, the Tax Court explained that "[a]s a general rule, taxpayers are not permitted to net interest income and expense in computing taxable income." Id. at 1286 (citing Murphy v. Commissioner, 62 T.C. 12 (1989)). Instead, the decisions permitting interest netting merely provide, within the context of the section 613 percentage depletion deduction for mining operations, an exception to the general rule.[6]

The Fifth Circuit reversed. The court was of the opinion that the Tax Court's reliance on Treas. Reg. § 1.861-8(e)(2) was misplaced, since section 1.861-8(e)(2) was not in effect for the

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[5] Treas. Reg. § 1.994-1(c)(6)(iii) provides:

> Costs (other than costs of goods sold) which shall be treated as relating to gross receipts from sales of export property are (a) the expenses, losses, and other deductions definitely related, and therefore allocated and apportioned, thereto, and (b) a ratable part of any other expenses, losses, or other deductions which are not definitely related to a class of gross income, determined in a manner consistent with the rules set forth in [Treas. Reg. §] 1.861-8.

[6] [redacted] points to the Service's acquiescence in both the General Portland and Ideal Basic cases as support for its position that interest netting is permissible. See AOD-CC-1986-022 (Feb. 26, 1996); AOD-CC-1986-023 (Feb. 26, 1996). However, each of these is limited to computation of the percentage depletion deduction limitation for mining operations under I.R.C. § 613(a). Both AODs recognize that the regulations under I.R.C. § 613 effectively require that the amount to be taken into account as a deduction for purposes of computing the 50 percent taxable income limitation is the amount claimed as a deduction for income tax purposes. The AODS reason that the effective amount of interest available as a deduction for tax purposes is the net cost of borrowing the money; not the higher book amount, which fails to take into account the fact that borrowed money has been reinvested. Requiring a taxpayer to use the higher book amount for purposes of the percentage depletion deduction would thus run counter to the percentage depletion regulations.

years at issue. Dresser, 911 F.2d at 1134-36.[7]

The Code and regulations as in effect for the years at issue were silent with respect to the practice of interest netting. Rather, noted the court, the regulation in effect for the years in issue could be read to either permit or preclude interest netting. Dresser, 911 F.2d at 1134-35 (citing Treas. Reg. § 1.861-8(a) (as amended in 1975)). More specifically, the Fifth Circuit found that the term "expenses" as used in the regulation could mean either (1) the specific itemized deduction for interest as set out in the Code, or (2) the actual cost of borrowing as explained in the General Portland decision. Id. at 1135. If "expenses" meant the former, then the regulations required the apportionment of gross interest expense; if the latter, then the regulations allowed for the apportionment of net interest expense. The Fifth Circuit chose the latter interpretation of "expenses." Id. The court noted that the then current version of Treas. Reg. § 1.861(e)(2) - which it had already pointed out did not apply to the years in issue - recognized that money is fungible:

> [w]hen money is borrowed for a specific purpose, such borrowing will generally free other funds for other purposes and it is reasonable ... to attribute part of the *cost of borrowing* to such other purposes.

Id. (quoting Treas. Reg. § 1.861-8(e)(2) (emphasis added by the Fifth Circuit)). Thus, in the court's view, the then current version of the regulations illustrated the principles underlying its General Portland opinion. Id. The court assumed that Congress would not have intended for its DISC legislation *not* to reflect the true cost of borrowing. Id. at 1136. Thus, given the silence of the statute and the perceived ambiguity of the applicable regulation, the Fifth Circuit concluded that the taxpayer's analogy to the section 613(a) percentage depletion deduction, as explained by its prior opinion in General Portland, was correct. Id.

Following the Fifth Circuit's decision in Dresser, the Tax Court changed its position and held that a taxpayer may net interest income against interest expense in determining the amount of the interest deduction to be allocated and apportioned in computing CTI. Bowater, Inc. v. Commissioner, 101 T.C. 207

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[7] However, the court expressed no opinion on whether interest netting was consistent with Treas. Reg. § 1.861-8(e)(2) as revised in 1977, or with Congressional intent behind the DISC provisions. Dresser, 911 F.2d at 1134 n.11.

(1993). The court distinguished its contrary opinion in Dresser, on the basis that Treas. Reg. § 1.861-8(e)(2) did not apply to the years at issue in Dresser, whereas it did apply to the taxpayer in Bowater. The court relied extensively on the principle that money is fungible, as explained by the Fifth Circuit in Dresser, and held for the taxpayer.

Following its opinion in Bowater, the Tax Court summarily held that a taxpayer "is entitled to offset interest income against interest expense in determining the amount of the interest deduction to be allocated and apportioned in computing combined taxable income under section 936 and [Treas. Reg. §] 1.861-8(e)(2)." Cola-Cola Co. v. Commissioner, 106 T.C. 1, 31 (1996). Again, in Computervision Int'l Corp. v. Commissioner, T.C. Memo. 1996-131, the Tax Court followed its opinion in Bowater and held that interest netting is permissible in computing CTI.

In 1997, the Second Circuit Court of Appeals reversed the Tax Court's decision in Bowater. Bowater, Inc. v. Commissioner, 108 F.3d 12, 13 (2d Cir. 1997), rev'g, 101 T.C. 207 (1993). As had the Fifth Circuit in Dresser, the Second Circuit based its opinion on its interpretation of the premise that money is fungible. Unlike the Fifth Circuit, however, the Second Circuit determined that this principle, as expressed in the 1977 version of Treas. Reg. § 1.861-8(e)(2), does not permit interest netting. Id. at 15-16.

Following the Second Circuit's opinion, the Commissioner filed a notice of appeal in Computervision. See Computervision Corp. v. Commissioner, 164 F.3d 73, 75 (1st Cir. 1999), rev'g, T.C. Memo 1996-131. The taxpayer then notified the Commissioner that it intended to concede the interest netting issue, and moved to dismiss the appeal as moot. The First Circuit Court of Appeals denied the taxpayer's motion, vacated the Tax Court's decision, and remanded the case "for recalculation of deficiencies on the premise that the taxpayers are not entitled to use the netting method for the years in issue." Id. at 76.

It is therefore clear that [redacted]'s reliance on precedent is somewhat precarious. Coca-Cola's summary conclusion, based on a Tax Court case that has since been reversed, leaves no analysis to support [redacted]'s position. Equally unavailing is the opinion in Computervision, since gutted by Bowater's reversal, the taxpayer's own concession, and the First Circuit Court of Appeals. The Actions on Decision to which [redacted] cites, while of no precedential value, are limited to the percentage depletion deduction limitation for mining operations under I.R.C. § 613(a); they are exceptions to the general rule. The only case upon

which [redacted] reasonably may rely is Dresser. However, the Second Circuit has since criticized the Fifth Circuit's analysis in Dresser, particularly its conclusion that permitting the netting of interest expense against interest income best accords with the concept that money is fungible. Thus, two circuits have reached opposite conclusions to the question whether interest netting comports with the expressed regulatory premise that money is fungible. Analysis of the reasoning behind these conclusions reveals that the Second Circuit's better comports with the principle.

In Dresser, 911 F.2d at 1135, the Fifth Circuit found that its interpretation of the fungibility-of-money premise articulated by Treas. Reg. § 1.861-8(e)(2)(i) was consistent with its prior decision in General Portland. Both, according to the Fifth Circuit, reflect the "realities of business finance." Id. According to the Fifth Circuit, the economic realities of business finance are essentially based upon timing. See id. The court posited that a business would typically assume a debt in a single transaction, but would not use all the funds at once. In order to reduce the cost of holding surplus cash, "a business will typically invest any cash surplus" in some sort of "short-term, interest-bearing instruments." Id. According to the Fifth Circuit, the difference between interest expense on the debt and interest income earned on the short-term investment of the surplus cash represents the "actual cost of borrowing." Id.

The Fifth Circuit continued that, in its General Portland opinion, it had held that the actual cost of borrowing was the amount properly allocable to mining operations for purposes of calculating the maximum depletion deduction. "To do otherwise, [it] reasoned, would be to allocate a disproportionate share of the business's financing costs to a specific phase of its operations." Dresser, 911 F.2d at 1136. Similarly, analogized the court, to require the apportionment of gross interest would disproportionately burden a DISC with the costs of borrowing attributable to all operations. Id.

The Fifth Circuit's analogy, however, is flawed. The computation of taxable income for purposes of the depletion deduction under section 613 allocates interest only to gross income from mining operations. However, under Treas. Reg. § 1.861-8(e)(2), for purposes of computing CTI, interest must be allocated ratably to *all* income producing activities. That is to say, whereas the depletion deduction is limited to mining, CTI is not limited to exporting operations. The reluctance to burden a mining operation with the costs of an entire operation in the case of the depletion deduction is unwarranted in the case of computing CTI.

Since Dresser, the Tax Court has followed the Fifth Circuit's analysis with little or no discussion. Indeed, in Bowater, the Tax Court simply recited portions of the text of the Dresser opinion. See Bowater, 101 T.C. at 211-14. However, in reversing the Tax Court in Bowater, the Second Circuit criticized the Fifth Circuit's reliance on "a debatable economic theory" as a basis for permitting interest netting. See Bowater, 108 F.3d at 14-16.

First, the Second Circuit noted that Treas. Reg. § 1.861-8(e)(2) expressly cites the fungibility-of-money premise to support its mandate that interest expense be allocated to *all* income producing activities. Bowater, 108 F.3d at 14. The practice of interest netting, however, "interprets [Treas. Reg. § 1.861-8(e)(2)] to mean that money paid in the form of interest expense is fungible only with money earned in the form of interest income, so the two sums must be balanced against each other to determine the amount of interest expense to be allocated to other forms of interest income." Id. at 15. In short, to permit interest netting would transmute the "fungibility-of-money" premise into a "fungibility-of-interest" premise.[8]

Next, the Second Circuit noted that the "actual cost of borrowing" concept explained by the Fifth Circuit in Dresser does not comport with the notion that money (as opposed to simply interest) is fungible. The Fifth Circuit's "actual cost of borrowing" approach reduces the management of funds to a singular cash flow: interest in and interest out. However, "cash positions change daily, even hourly, as cash flows in from an array of sources, not just from interest bearing sources, and flows out to pay an array of expenses, not just interest expense." Bowater, 108 F.3d at 15.

In other words, investing surplus cash in short-term,

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[8] The Tax Court made this same error. In Bowater, the Tax Court stated that "[f]or purposes of 861, *interest* is assumed to be fungible." Bowater, 101 T.C. at 211 (citing Treas. Reg. § 1.861-8(e)(2)) (emphasis added). The Tax Court further relied on Dresser in claiming that interest netting "avoids unequal treatment of taxpayers with the same amount of actual interest cost, just as the *fungibility-of-interest* concept avoids unequal treatment of taxpayers whose indebtedness is structured differently." Id. at 212 (emphasis added). The Tax Court repeated this error in Computervision, T.C. Memo. 1996-131, when it stated that "interest is assumed to be fungible for purposes of [Treas. Reg. § 1.861-8(e)(2)]."

interest-bearing instruments is fundamentally no different from investing surplus cash in inventory or dividend-bearing stock. In either circumstance, cash continues to flow in from and out to various sources. Management should have great flexibility to direct this cash flow as it sees fit. To allow otherwise would again lead to the creation of a fungibility-of-interest premise.

The Fifth Circuit opined that disallowance of interest netting under Treas. Reg. § 1.861-8(e)(2) would "burden a DISC with a disproportionate share of the actual borrowing costs attributable to all operations, not merely to export operations." Dresser, 911 F.2d at 1136. Further, in relying on Dresser, the Tax Court in Bowater argued that interest netting would prevent "unequal treatment of taxpayers whose indebtedness is structured differently." Bowater, 101 T.C. at 212. However, as the Second Circuit recognized, the practice of interest netting *itself* leads to disproportionate results among differently-situated taxpayers:

> Suppose DISC #1 invested its temporary cash surplus in interest bearing securities while DISC #2 invested in dividend paying stock. Under [the interest netting] approach, DISC #1 and its related supplier would allocate interest expense to interest income prior to allocating the remaining "net interest expense" to the income earned from the sale of export property. Meanwhile, DISC #2 and its related supplier would allocate the interest expense, unreduced by interest income, to the income earned from the sale of export property as well as to the dividends earned from the stock investment. [The interest netting approach] would result in a higher CTI in the first DISC and its related supplier than in the second, solely because of the nature of the investment of surplus funds.

Bowater, 108 F.3d at 16. Thus, the only real equality that interest netting provides among differently structured forms of indebtedness is among those forms that invest temporary cash surplus in interest-bearing investments. Indeed, in its explanation of the "economic reality" of dealing with a temporary cash surplus, the Fifth Circuit only cited to interest-bearing forms of investment. See Dresser, 911 F.2d at 1135 (using the examples of (1) a short-term interest bearing instrument and (2) the purchase of other presumably interest-bearing investments).

In short, contrary to [redacted]'s contention and the Fifth Circuit's opinion in Dresser, the fungibility-of-money premise does not support the conclusion that interest netting is permissible. Rather, the fungibility-of-money premise

acknowledges simply that cash flow is fluid and non-linear, and that management should be granted a great deal of latitude in determining its source and use. Further, as the Second Circuit recognized in Bowater, Temp. Treas. Reg. § 1.861-9T(a), which added the sentence "[t]he term interest refers to the gross amount of interest expense incurred by a taxpayer in a given tax year," merely clarifies or reiterates Treas. Reg. § 1.861-8(e)(2), which respects the fungibility-of-money premise, not a fungibility-of-interest premise. See Bowater, 108 F.3d at 17. See also Dresser Indus. v. United States, 1999 U.S. Dist. LEXIS 10663, at *34 (N.D. Tex. June 25, 1999), in which the District Court for the Northern District of Texas held that the 1977 version of Treas. Reg. § 1.861-8(e)(2) (which version the Fifth Circuit in the first Dresser opinion expressly declined to address) precludes interest netting.

**Legislative History of the Tax Reform Act of 1986**

Just as [redacted]'s reliance on precedent to support a fungibility-of-interest premise is misplaced, so, too, is [redacted]'s reliance on its own interpretation of Congressional intent as a reflection of "economic reality." In the legislative history to the Tax Reform Act of 1986, Congress did indicate concern that then existing sourcing regulations did not reflect "economic reality." See, e.g., S. Rep. No. 99-313, 99th Cong., 2d Sess., at 346. However, the concern was that consolidated companies should not be permitted to allocate based on a separate company approach, but rather should be required to allocate on a consolidated basis and to use the asset method (rather than the formerly permissible optional gross income method) of allocating interest, in order to avoid manipulation of U.S. source income. Id. at 346-350. In the latter respect, the Senate "adopt[ed] the theory of the Treasury Regulations concerning the general preferability of the asset method (see Treas. Reg. sec. 1.861-8(e)(2)(v))." Id. at 349. Accordingly, Congress amended Code section 864 by adding new subsection 864(e), which requires that all allocations and apportionments of interest be made as if all members of an affiliated group were members of a single corporation, and must be made on the basis of assets rather than gross income.

Nowhere does the legislative history to the 1986 Act suggest that Congress believed that allowing netting of interest expense against interest income better reflected economic reality or implemented fungibility of money concepts than requiring the apportionment of gross interest expense against all income. In fact, the opposite can be inferred from Congress' displeasure with the separate company approach.

> [T]he Committee intends that regulations will provide appropriate treatment to effectively eliminate interest payments among members of an affiliated group that join (or could join) in the filing of a consolidated return. *Therefore, the only interest expense taken into account is interest paid to non-members of the group.*

(Emphasis added.) If Congress had intended that the "interest paid to non-members of the group" should further be reduced by interest income from third parties, it would have stated as much. In short, contrary to [redacted]'s assertion, "[e]conomic reality," particularly a judicial interpretation of economic reality, "is no longer a relevant consideration [for the question of interest netting]." Dresser Indus., 1999 U.S. Dist. LEXIS 10663, at *34. Thus, the Treasury regulation requiring the apportionment of gross rather than net interest expense does not conflict with the legislative history to the 1986 Act.

**Treas. Reg. § 1.861-9T(a) Is Valid**

In determining the propriety of the challenged portion of a regulation, courts begin with the general proposition that the Commissioner has broad authority to promulgate all needful regulations. I.R.C. § 7805(a). Courts ordinarily defer to the Commissioner's interpretive regulations because "Congress has delegated to the Commissioner, not to the courts, the task of prescribing [such regulations]." National Muffler Dealers Ass'n v. United States, 440 U.S. 472, 477 (1979). It is well settled that Treasury regulations must be sustained unless unreasonable and plainly inconsistent with the revenue statutes. Fulman v. United States, 434 U.S. 528, 533 (1978); Bingler v. Johnson, 394 U.S. 741, 750 (1969). The Supreme Court has repeatedly declared, in strong and unequivocal terms, that Treasury regulations should not be struck down lightly. See, e.g., Commissioner v. Portland Cement Co., 450 U.S. 156, 169 (1981). In determining whether a particular regulation carries out the Congressional mandate in a proper manner, courts look to see whether the regulation harmonizes with the plain language of the statute, its origin and its purpose. United States v. Vogel Fertilizer Co., 455 U.S. 16 (1982); National Muffler Dealers, 440 U.S. at 477.

Aside from Temp. Treas. Reg. § 1.861-9T(a), the Code and the regulations are silent as to the propriety of interest netting. In fact, "[t]here is no statutory authority allowing one to net interest expense against interest income." Murphy v. Commissioner, 92 T.C. 12, 15 (1989). The only exception that exists is the judicially-created exception relating to the computation of the 50 percent limit of taxable income from mining property under section 613(a). Id. at 15 n.4. Nothing in the

plain language of the statute permits interest netting. Consequently, it is not unreasonable, nor is it plainly inconsistent with the revenue statutes, or with the legislative history of the Tax Reform Act of 1986, for Temp. Treas. Reg. § 1.861-9T(a) to require the apportionment of gross rather than net interest expense.

With nothing more than the support of a distinguishable Fifth Circuit opinion, it cannot be said that Temp. Treas. Reg. § 1.861-9T(a) contravenes Congressional intent or exceeds statutory authority. The requirement in Temp. Treas. Reg. § 1.861-9T(a) that a taxpayer apportion gross interest expense therefore is valid.

**The § 6662 Standards**

Section 6662 imposes a penalty equal to 20 percent of the part of an underpayment of tax that is attributable to negligence or disregard of rules and regulations. I.R.C. §§ 6662(a) & (b)(1). For purposes of section 6662, negligence is a failure to reasonably attempt to comply with the provisions of the Internal Revenue Code. I.R.C. § 6662(c). Negligence is defined as a "'lack of due care or failure to do what a reasonable and ordinarily prudent person would do under the circumstance.'" Neely v. Commissioner, 85 T.C. 934, 947 (1985) (quoting Marcello v. Commissioner, 380 F.2d 499, 506 (5th Cir. 1967)). Further, for the purpose of section 6662, the term "disregard" includes any careless, reckless or intentional disregard. I.R.C. § 6662(c). Petitioner has the burden of proving that the Commissioner's determination of an addition to tax is in error. Luman v. Commissioner, 79 T.C. 846, 860-861 (1982).

However, the penalty will not be imposed on any portion of an underpayment that is attributable to a position contrary to a rule or regulation if:

(1) the position is disclosed;

(2) the position has a reasonable basis;

(3) the taxpayer keeps adequate books and records;

(4) the taxpayer substantiates items properly; and

(5) the position represents a good faith challenge to the validity of the regulation.

Treas. Reg. §§ 1.6662-3(c)(1); 1.6662-7(b). Disclosure is adequate if (1) a taxpayer properly completes and files a Form

8275 or Form 8275-R, and (2) the statutory or regulatory provision or ruling in question is adequately identified in the Form 8275 or Form 8275-R. Treas. Reg. § 1.6662-4(f)(1).

Thus, [redacted] is correct in stating that the realistic possibility standard of Treas. Reg. § 1.6662-3(b)(2) is not the correct standard of relief from the accuracy-related penalty. The proper standard of relief from the accuracy-related penalty where the taxpayer takes a position that is contrary to the rules and regulations is that the position is disclosed, has a reasonable basis, and represents a good faith challenge to the validity of the rule or regulation.

If you have any further questions, please feel free to contact Scott Shieldes at 281-721-7308 or Carol McClure at 281-721-7306.

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